ISLAMIC FINANCIAL SYSTEM

Deepak Godbole
General Insurance Corporate of India, Mumbai

1. Economic growth, wealth creation & finance:

1.1 A modern welfare state performs four economic functions, viz. establishing the legal framework for the economy; directing allocation of resources to improve economic efficiency; establishing programmes to improve distribution of income and stabilising the economy through macroeconomic policies. Goals of macroeconomic policy are full employment, price stability, economic growth and comfortable Balance of Payment situation. Money, credit & finance are the life blood of the economic system. Wealth creation involves using goods and services (wealth) already available in the economy. Money or finance makes it possible to cycle existing wealth to create further wealth.

1.2 Acquisition and allocation of financial resources so as to minimise the cost & maximise the return consistent with the level of acceptable financial risk is the core of financial management. Financial system is a set of complex intermix of financial institutions, markets, instruments, services, practices & procedures with a meaningful & effective role played by supervisory/ regulatory bodies. The financial system is concerned about money, credit & finance. Money refers to the medium of exchange, credit is the sum of money to be normally returned with interest & finance is monetary resources comprising owned & loaned funds.

2. Economic well being & socio-religious framework:

2.1 The price in financial markets is known as the rate of interest. Under conditions of perfect competition, the equality between total expected demand for funds and the total planned supply of funds determines the equilibrium rate of interest. A variety of short term, medium term & long term interest rates exist in financial system. Of all those things that would guard the money, banks became the main source of credit creation.

2.2 Economic well being is the primary goal of development. It is one thing to be a wealthy nation but unless that wealth is spread medium/ long term stability cannot be guaranteed. Behavioural economics is a branch of economics that concentrates on explaining the

economic decisions people make in practice, especially when these conflict with what conventional economic theory predicts. Behaviourists try to augment or replace traditional ideas of economic rationality with decision-making models borrowed from psychology. Economic growth involves many aspects of socio-cultural institutions. Institutions, culture and attitudes are undoubtedly important determinants of economic and social progress of a country. Social attitudes lead or follow economic change and they sometimes work cumulatively. Culture, institutions and attitudes influence one another, either directly or indirectly.

3. Islamic law & Islamic finance:

3.1 Islamic law, or sharia, forbids either paying or charging interest. Islamic economics is based on 'socio economic justice' as the primary objective. It is based on the belief that human beings are a creation of that one & the only god and all resources at their disposal are held by them in trust for the god to be used in a just manner for wellbeing of all. However, it is not the same as the secularism in as much as the human wellbeing is not considered to be dependent primarily on maximising consumption & wealth but it requires moulding of social behaviour in accordance with the Sharia (muksad al Sharia). The primary function of Islamic economics is the realisation of wellbeing through actualisation of muksad. It means achieving human wellbeing through organisation of resources through cooperation & participation. Quran & Sunnah provide norms about how economic agents should behave & what policies should be adopted to realise the kind of wellbeing that Islam stands for.

3.2 In Islam, there is no separation between the secular and the sacred. The law is suffused with religion[1]. Sharia, or Islamic law, influences the legal code in most Islamic countries, but the extent of its impact varies widely. Islamic Sharia is not an easily identifiable set of rules that can be mechanically applied, but a long & quite varied intellectual tradition. According to Islamic teaching, Sharia is revealed in divine signs that must be interpreted by humans. The law is derived from four main sources:

- the Quran, Islam's holy book, considered the literal word of God;
- the hadith, or record of the actions and sayings of the Prophet Mohammed, whose life is to be emulated;
- ijma, the consensus of Islamic scholars; and

---

[1] *David Powers, Professor of Islamic law and history at Cornell University.*

- qiyas, a kind of reasoning that uses analogies to apply precedents established by the holy texts.

3.3 Though Sharia influences the legal code in most Islamic countries, the impact of the Islamic law varies widely even in Islamic economies. At one end in countries like Iran & Saudi, Quran is considered the constitution while at the other end, Turkey does not base its laws on Quran and Government promotes certain practices that are often understood as far from Islamic. Interestingly, there exist five major schools of Sharia developed after the death of the Prophet Mohammed and during the middle ages. Middle Eastern countries of the former Ottoman Empire follow Hanafi school doctrine, North African countries prefer Maliki doctrine; Indonesia and Malaysia follow Shafi doctrine; Saudi Arabia adheres to Hanbali doctrine and Iran follows the Jaafari school.

4. Islamic finance:

4.1 'Islamic finance', sometime back considered as more of a theoretical concept than reality, seems to be shaping up. The market for Islamic financial products—banking, mortgages, equity funds, fixed income, insurance, project finance, private equity and even derivatives is estimated to be growing at about 15% annually in the past few years. Having made a sound beginning in Muslim dominated economies like Malaysia and Bahrain, Islamic finance now appeals to some of the world's biggest financial institutions which consider it as a 'parallel financial system', that can not be ignored. In the words of Dr Zeti Akhtar Aziz, ex Governor of Bank Negara Malaysia, 'Islamic finance is a corporate, social responsibility movement of the educated, enlightened Muslim middle classes'.

4.2 One of the important features that is crucial to modern economics is 'interest', the fee charged for the opportunity of borrowing money. Interest spurs economic efficiency and creates wealth by helping borrowers & lenders make exchanges to their mutual advantage. Financial instruments in contemporary financial markets are based on interest which is prohibited in Islam. But Islam does not seem to be totally averse to the idea of financial intermediation. Financial intermediation involves bringing together those who have spare money in contact with those who are in need of money. Thus, the surplus & deficit units in terms of possession of financial resources are required to cooperate for efficient use of resources. Banks do financial intermediation. Historically, it is observed that Mudaraba or Mukradah had offered a mechanism of financial intermediation in early times in Arab world. Mudaraba was said to be prevalent in Makkah & Medina in trade activities in long past. Over a period of time some more methods/ facilitators of financial markets such as Musharaka (profit sharing), Murabaha (mark up sale) & Ijarah (leasing) got developed & got sanctity under Islamic laws.

4.3 Though, Islam recognizes capital as a factor of production, it does not allow the factor to make a prior or pre-determined claim on the productive surplus in the form of interest. Their Islamic beliefs prevent Muslims from dealings that involve interest (Riba) regardless of the purpose or rate being charged. However, people in Islamic nations need banking & other financial services for many purposes such as financing new businesses, buying property, buying vehicles etc. To be called as Sharia compliant, an Islamic financial product should adhere to two principles: it must not pay interest and wealth should not be generated from means considered improper.

5. Islamic banking:

5.1 Islamic banks around the world have been devising creative financial products based on the risk-sharing, profit-sharing principles. Islamic banking has three distinguishing features: (a) it is interest-free, (b) it is multi-purpose & not purely commercial and (c) it is strongly equity-oriented. Islamic researchers mention that 'Islamic finance is not only for Muslims, it is for entire humanity' as said in the holy literature. According to the supporters of the idea of Islamic banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral as in case of the conventional banking. Some developmental projects which might get turned down by conventional banks for lack of collateral could be financed by Islamic banks on a profit-sharing basis. Under Islamic banking, if a business is interested in purchasing property, instead of borrowing money to make the purchase (which would involve payment of interest), bank acquires the property and leases it out for a set fee.

5.2 The first experiment with Islamic banking is said to have been in Egypt in l963. The banks neither charged nor paid interest, but invested mostly by engaging in trade and industry, directly or in partnership with others and shared the profits with their depositors. They resembled saving/ investment institutions rather than commercial banks and actually were declared as interest-free commercial banks, without any reference to Islam or Sharia. In 70s, however, some specific Islamic banks came into existence in Dubai, Sudan, Egypt and Bahrain. In 80s, Islamic banks were established in Philippines & Malaysia. The thing thereafter moved from Muslim dominated economies to places where there is Muslim minority such as Luxembourg, Denmark & Australia. The Islamic financial services industry now comprises of Islamic commercial & investment banks, windows of conventional banks, Mudaraba companies and Islamic Insurance companies. After about two decades of its introduction, Islamic banking is there to stay in many parts of the world, especially, in the middle eastern region & Malaysia which is a confluence of about 55% Malay Muslims, 35% Chinese & 10% South Indians.

5.3 Islamic banking is one of the fastest growing segments of the global banking system. Many international banks are offering Sharia compliant products of their own. Citibank has been offering Islamic products since the 1990s. ABN Amro, BNP Paribas, Standard Chartered and Goldman Sachs have jumped into the arena. A number of other financial conglomerates are looking at this very closely. A multinational banker while explaining Islamic finance quotes that "Islamic finance has always been about community banking, ethical investments, affinity marketing and investment in the real economy".

5.4 A study[2] had found Islamic banking to be a viable proposition that can result in efficient resource allocation. It states that banks in an Islamic system are likely to face fewer solvency and liquidity risks than their conventional counterparts. However, the study also brings this fact to light that Islamic banking poses serious practical problems, especially in relation to the skills needed to handle diverse & complex transactions. Some other views by researchers on Islamic banking are also worth taking a note of. Some of these being:

- The stress on equity-oriented transactions in Islamic banking, especially the mudaraba mode is questioned through an argument that the replacement of pre-determined interest by uncertain profits is not enough to render a transaction Islamic, since profit can be just as exploitative as interest is, if it is not reasonable.

- Islamic banks show a preference for trade finance and real estate investments and the relative profitability of Islamic banks to a large extent could be attributed to the real estate boom.

- Islamic financial institutions as well as the capital and money markets need to be firmly reinforced by the legal and regulatory framework that adequately address the unique characteristics of Islamic financial system.

- Standards for financial reporting, accounting & auditing need to be established at global level (may be something like Islamic financial services authority).

- Most importantly, Islamic banking has to address the requirements of individual savers who simply wish to park their funds for a rainy day/ old age (savings, term deposit accounts carrying reasonably low risks & giving return in the form of interest in conventional banking)

[2] *IMF study by Iqbal and Mirakhor (l987)*

6. Islamic insurance- Takaful

6.1 While more attention naturally is given to Islamic banking, Islamic insurance- takaful is also growing fast. Takaful in Arabic, means joint guarantee. Principles of takaful are similar to those that underpin mainstream mutual insurance. This Islamic alternative to insurance, is based on the concept of social solidarity, cooperation and mutual indemnification of losses of members. It is an accord among a group of persons who agree to jointly indemnify the loss or damage that may be caused, out of the fund they donate collectively. Such a contract usually involves the concepts of Mudaraba, Tabarru (to donate for benefit of others). It is based on the concept of mutual sharing of losses with the aim of eliminating the element of uncertainty. Takaful represents an important component in the overall Islamic financial system given its role in the mobilisation of long-term funds and providing risk protection. Takaful is a way to reduce the financial risk of loss due to accident and misfortunes. In takaful, the participant would pay particular amount of money as contribution (premium) partly to risk fund (the participants' special account) using the concept of tabbaru (donation) and another party (takaful organisation) with a mutual agreement that there would be a legal responsibility to provide for the participants a financial protection against unexpected loss, should it happen within the agreed period.

6.2 Takaful is said to be begun in Sudan and then got spread to Asia, with Malaysia, one of the most mature takaful markets and now rapidly spreading in the Middle Eastern region. A number of takaful companies exist in Sudan, the Middle East, Far East, Iran, Pakistan, Turkey and Malaysia. Many multinationals are keen to capture a slice of the growing Takaful market. Takaful market growth naturally leads to re-takaful market development. International companies moving into takaful/ retakaful include AIG, Allianz, Aviva, Prudential, Axa and HSBC. Munich Re, Swiss Re and Hannover Re have takaful reinsurance businesses.

6.3 While takaful insurance is mainly in Asia and the Middle East, there are indications that the concept is spreading elsewhere. The UK's Financial Services Authority is believed to be open to encouraging takaful products in the UK, although providers would be required to comply with its regulatory framework. Insurers & reinsurers are also evaluating options to have separate Takaful windows in Germany, Turkey and other places with a sizable Muslim population.

6.4 Like Islamic banking, there are certain issues in development & growth of takaful & retakaful markets. Retakaful is unlikely to prosper without sound development of takaful primary operations. Development of technical expertise for both takaful and retakaful, need for a unified system for takaful/ retakaful operations globally, developing takaful awareness and unified rules for regulating takaful industry are some of the major issues that need immediate attention.

6.5 To summarise, based on the concept of relative scarcity, economics[3] is conventionally defined as "the study of how people & society choose to employ scarce resources that could have alternative uses in order to produce various commodities and to distribute them for consumption amoung various persons & groups in a society". The logic of relative scarcity seems to have been explained in Quran as well with minor changes. Instead of 'relative scarcity', it is seen and termed as 'available resources endowed by Allah'. As per supporters of Islamic finance, financial intermediation is possible without 'interest' & riba-free Islamic banking could be more conducive to growth & development and would lead to a more equitable distribution of income & wealth. Funds through Islamic finance are likely to be allotted to more productive purposes (equitable allocation & fair distribution) than being made available to borrowers on the prime basis of creditworthiness as in conventional financing. Takaful & retakaful are parts of Islamic financial architecture. Following the growth path of Islamic banking, both takaful & retakaful organisations are growing in numbers, popularity & size all over the globe.

6.6 Insurance is a business of risk, finance & investment. The growth & success of takaful and retakaful is directly linked to the asset management capabilities of the Islamic finance. Takaful premiums have to be invested in a Sharia compliant manner and in a profitable manner. It is clear that Islamic financial system can fulfill the basic tasks required of any financial system. The history of Islamic financing is not very long and with learning from the experience, the system will no doubt settle.

---

[3] *Samuelson & Nordhous*

References:

"Banking without Interest", "Islamic economics"- Siddiqi

"Islamic banking", "Islam & economic challenge"- Chapra

'Nidaul Islam' magazine- Various issues

Islamic Development Bank & Islamic Development Training Institute

❑❑❑